BEFORE THE
TENNESSEE STATE BOARD OF EQUALIZATION

In Re:	Acorn Hills L.P. District 3, Map 001A, Group C, Control Map 005A, Parcel 18.01 Tax years 2003, 2004	))))	Marshall County

INITIAL DECISION AND ORDER

Statement of the Case

The Marshall County Board of Equalization has valued the subject property for tax purposes as follows:

LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
$220,000	3,209,500	$3,429,500	$1,371,800

Appeals have been filed on behalf of the property owner with the State Board of Equalization ("State Board").

The undersigned administrative judge conducted a hearing of this matter on July 12, 2007 in Nashville.[1] The appellant, Acorn Hills L.P., was represented by registered agent Patrick H. Musgrave, of Evans & Petree, PC (Memphis). Marshall County Assessor of Property Linda Haislip was assisted by Robert T. Lee, attorney for the State Division of Property Assessments (DPA), and George C. Hoch, TMA, a member of DPA's staff.

Findings of Fact and Conclusions of Law

The property in question is one of several Low Income Housing Tax Credit ("LIHTC") projects which were embroiled in a dispute (for the 1998 tax year) that was ultimately resolved in Spring Hill, L.P. v. State Board of Equalization, 2003 WL 23099679 (Tenn. Ct. App. 2003).[2] Built in 1996 at a certified cost of about $3.8 million, "Acorn Hills" consists of 44 detached single-family dwellings on a 5.47-acre site in the city of Lewisburg.[3] Upon the developer's application, the Tennessee Housing Development Agency (the state administrator of the LIHTC program) awarded a total of $3,785,240 in LIHTCs for this project – i.e., $378,524 per annum for a ten-year period beginning September 30, 1997. In return, the property owner committed to rent all of the units to eligible low-income individuals at restricted rates for a 30-year term ending in November, 2026. The Land Use Restrictive Covenants ("LURC") also effectively prohibit the

[1]The parties filed post-hearing memoranda on or before the August 1, 2007 due date.

[2]The Spring Hill decision upheld inclusion of the value attributable to the federal income tax credits in the appraisal of LIHTC properties for ad valorem tax purposes, as well as the reclassification of Acorn Hills as commercial property.

[3]Acorn Hills contains an equal number of one- and two-story units.

owner for an additional three-year period from evicting an existing tenant (except for good cause) or raising the gross rent for any unit (unless "expressly permitted").

Construction of Acorn Hills was financed largely by the $2,649,530 ($0.70/$1.00) proceeds from the assignment of the LIHTCs. In addition, the developer procured a mortgage loan of $650,000 at a 6.13% interest rate.

Given the paucity of arm's-length sales of "Section 42" housing projects, the parties agreed that this investment property should be valued by an income capitalization approach. But whereas Mr. Hoch relied solely on a discounted cash flow (DCF) analysis, Mr. Musgrave placed equal weight on direct capitalization at an overall rate of one year's stabilized net operating income (NOI) plus the "tax adjusted" present value of the remaining tax credits. Mr. Hoch faulted this "hybrid" methodology on the ground that:

> The taxpayer makes no attempt to include the value to ownership of the conversion from subsidized to conventional housing at the conclusion of the mandatory rent controlled holding period. The only technique that allows for that return is the insertion of the Reversionary Interest.

Assessor's Hearing Exhibit, p. 65.

Describing Acorn Hills as superior to most federally subsidized apartment complexes, Mr. Hoch posited that the subject houses would be sold individually (as single-family residences) at the end of the compliance period. From recent sales of purportedly comparable residences, he inferred that the market rent for these homes would increase by 3% per year throughout that period.[4] Mr. Hoch expounded on this point as follows:

> In effect, the value of the tax credits, inserted into the front end of the holding period, is returned when the terminal cap rate is applied to the higher conventional as opposed to the lower subsidized net operating income (NOI) in the year following the end of the holding period.

Ibid.

Not surprisingly, the taxpayer's agent had a less sanguine outlook. In his DCF spreadsheet, the expiration of the LIHTCs in 2007 marked the end of the holding period; and the reversionary value was calculated on the basis of the restricted rents still in effect at that time. Mr. Musgrave claimed that the Assessor's sharply higher, market rent-driven reversionary value "double counts the tax credit value." Taxpayer's Memorandum, p. 2.

The key differences between the parties' DCFs for the tax years in controversy may be summarized as follows:

Component	Taxpayer	Assessor
Holding period	Duration of tax credits	Duration of compliance period

[4]Mr. Hoch adopted as the "base" market rent the amount determined in a 1998 fee appraisal of the subject property.

Potential gross (restricted) rental income escalation	1.50%	2.50%
Discount rates	11.30% (2003) 10.80% (2004)	Split rates: 7.06% for NOI excluding tax credits; 6.77% (2003) and 7.93% (2004) for tax credits
Reversionary values	$1,029,000 (2003) $1,058,000 (2004)	$4,729,480 (2003) $4,753,000 (2004)

Mr. Hoch lauded the "benefits" of being able to incorporate into his 2003—2007 cash flow forecasts the actual income and expense data reported by the property owner for the preceding calendar years. He acknowledged that his analysis would have been somewhat different had such information not been available. Further, unlike the taxpayer's agent, Mr. Hoch treated the tax credits as income to the property owner in the year *after* the scheduled allotment of them. Thus, from his perspective, the LIHTCs would continue to supplement NOI (and thus enhance the value of the property) through *2008* – not 2007.

The conflicting estimates of market value indicated by the DCFs were as follows:

Tax Year	Taxpayer	Assessor
2003	$2,169,000	$3,172,000
2004	$1,990,000	$3,018,000

Tenn. Code Ann. section 67-5-601(a) provides (in relevant part) that "[t]he value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for purposes of sale between a willing seller and a willing buyer without consideration of speculative values."

As the party seeking to change the current assessment of the subject property, the taxpayer has the burden of proof in this administrative proceeding. State Board Rule 0600-1-.11(1).

Mr. Musgrave's "direct capitalization" technique actually indicated slightly *higher* values for Acorn Hills than those suggested by his DCF analysis. In the context of these appeals, then, it seems unnecessary to dwell on the Assessor's objections to that part of the taxpayer's so-called "hybrid" appraisal methodology.

Concerning the other major points of disagreement, the administrative judge briefly observes as follows:

Holding period. By conventional real estate standards, a 30-year holding period would be considered extremely long. *See*, e.g., Appraisal Institute, *The Appraisal of Real Estate* (12th ed. 2001), p. 570. But like the type of federally subsidized apartment complex involved in Troy Place Apartments (Obion County, Tax Year 1992, Final Decision and Order, November 12, 1993), LIHTC properties surely constitute an "identifiable submarket" which operates under unique rules and influences. *See* Tennessee Partners XII LP (Dickson County, Tax Years

2001—2004, Initial Decision and Order, November 10, 2005). From a practical standpoint, the expiration of the ten-year tax credit period seemingly lacks much significance; for – as in the case of Acorn Hills – the tax credits are usually assigned at the outset to help fund development costs. Moreover, the taxpayer's agent introduced no specific market data to substantiate a ten-year holding period. Indeed, as previously mentioned, there have been very few unforced sales of LIHTC properties since the inception of the program some 20 years ago. Hence the administrative judge is not inclined to alter the 30-year holding period in Mr. Hoch's DCF analysis.

Rental income escalation. While Mr. Hoch's 2.50% figure may be somewhat more congruous with the national apartment market rent surveys in the record, Mr. Musgrave's 1.50% proposal better reflects the historical operating data for the LIHTC property in question as well as the published data. From 2000 through 2003, according to the information furnished by the taxpayer, Acorn Hills achieved no rent growth at all.

Discount rates. For a suitable *internal rate of return* (IRR) in their DCFs, both parties consulted the *RERC Real Estate Report* published by the Real Estate Research Corporation. The taxpayer's agent selected the average fourth-quarter 2002 and 2003 rates for "second tier" apartments in the South region (11.30% and 10.80%, respectively), and discounted the projected NOI (including the tax credits) for each year covered by his DCF analysis accordingly. For Mr. Musgrave, by RERC's own definition, the IRR *was* the discount rate. Mr. Hoch, on the other hand, averaged the rates reported by RERC for "second tier" investment properties for the later years *2005* and *2006* to obtain his somewhat lower IRR (9.85%). More importantly, the unflappable DPA veteran calculated the supposed "discount rate" by a band-of-investment technique in which 75% of the weight was placed on the 6.13% mortgage component and only 25% on the 9.85% equity yield rate. Thus the rate at which Mr. Hoch discounted the rental income and reversionary value in his DCF was *less* than his going-in and terminal capitalization rates (8.00% and 8.50%, respectively).[5]

In the opinion of the administrative judge, Mr. Hoch has misapprehended the nature of the *discount rate* contemplated in a DCF which is admittedly predicated on an un-leveraged investment (before income taxes). By factoring a return *of* the amount received for the tax credits in his proposed 7.06% rate, he has overstated their effect on the market value of the ownership interest in the subject property.

The administrative judge does concur with Mr. Hoch that a separate discount rate for the tax credit portion of the income stream is warranted. *See* International Association of Assessing Officers, *Property Appraisal and Assessment Administration* (1990), p. 288. Although the

[5]Mr. Hoch's terminal capitalization rate was also based on 2005-2006 RERC data.

possibility of recapture of LIHTCs due to noncompliance with the LURC cannot be ignored, that element of the risk associated with the subject property is undoubtedly lower. In fact, no examples of outright default in the LIHTC program were cited.

But as the taxpayer's agent succinctly put it, Mr. Hoch "forced his discount rate for tax credits to a predetermined conclusion of $0.80 per dollar." Taxpayer's Memorandum, p. 9. Thus Mr. Hoch's proposed tax credit discount rate *increased* as the amount of time remaining in the compliance period *decreased* – an anomalous proposition. Moreover, his $0.80/$1.00 figure was apparently founded on a 1998 independent appraisal report (by Adkins & Associates) that must be discounted as hearsay.

It seems more plausible to suppose that the tax credit discount rate would be about midway between the mortgage interest and equity yield rates at, say, 8%.

Timing of receipt of tax credits. Mr. Hoch's position on this issue is especially ironic considering the liberal use of post-assessment date performance and survey data in his DCF analysis – contrary to the holding in Acme Boot Company & Ashland City Industrial Corporation (Cheatham County, Tax Year 1989, Final Decision and Order, August 7, 1990). In the mind of the administrative judge, the pertinent inquiry is whether the property owner would reasonably expect on the assessment dates for the tax years under appeal to receive the LIHTCs in the same years indicated on the tax credit schedule. The Acme Boot case hardly precludes such inquiry, which must be answered in the affirmative.

Reversionary value. Particularly given the extended holding period and the lack of rent comparables, the administrative judge cannot accept the reversionary value which was predicated on an average 3% annual increase in market rental rates. Of course, some degree of speculation is inherent in any DCF; but it strains credulity to suppose that 44 aging rental houses simultaneously unleashed on the Lewisburg real estate market would be absorbed within one year for upwards of $107,000 per unit (net).

In light of the foregoing comments, the administrative judge respectfully recommends adjusted valuations of the subject property in accordance with the following alterations to DPA's DCF Spreadsheets:

Tax Year 2003 (Assessor/DPA Hearing Exhibit, pp. 109-110):

Potential gross (restricted) rental income escalation: 1.50% per year (beginning with year 2)
Vacancy and collection loss: 5.00% of potential gross income (beginning in year1)
Expense escalation: 3.00% per year (beginning with year 2)
Discount rates: 11.30% for NOI excluding tax credits; 8.00% for tax credits
Years of tax credits remaining: 5
Terminal capitalization rate: 9.60%
Reversionary value: based on capitalization of rent-restricted NOI at end of holding period (less selling expenses)

Tax Year 2004 (Assessor/DPA Hearing Exhibit, pp. 113-114):

> Potential gross (restricted) rental income escalation: 1.50% per year (beginning with year 2)
> Vacancy and collection loss: 5.00% of potential gross income (beginning in year 1)
> Expense escalation: 3.00% per year (beginning with year 2)
> Discount rates: 10.80% for NOI excluding tax credits; 8.00% for tax credits
> Years of tax credits remaining: 4
> Terminal capitalization rate: 9.40%
> Reversionary value: based on capitalization of rent-restricted NOI at end of holding period (less selling expenses)

Order

Within ten (10) days from the date of entry hereof, the Assessor and/or DPA shall submit for the record revised DCF spreadsheets reflecting adjusted values for the subject property consistent with the above findings. It is further ORDERED that the following values be adopted for the tax years under appeal:

Tax Year 2003: Assessor/DPA adjusted DCF value less $7,968 (appraised value of tangible personal property).

Tax Year 2004: Assessor/DPA adjusted DCF value, equalized by application of the overall appraisal ratio certified by the State Board for Marshall County (.9625), less $7,968 (appraised value of tangible personal property).

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal **"must be filed within thirty (30) days from the date the initial decision is sent."** Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **"identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"**; or
2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 29th day of October, 2007.

Pete Loesch

PETE LOESCH
ADMINISTRATIVE JUDGE
TENNESSEE DEPARTMENT OF STATE
ADMINISTRATIVE PROCEDURES DIVISION

cc: Patrick H. Musgrave, Evans & Petree, PC
Robert T. Lee, General Counsel, Comptroller of the Treasury
Linda Haislip, Marshall County Assessor of Property

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